

No. 15273

**In the United States Court of Appeals
for the Ninth Circuit**

PACIFIC VEGETABLE OIL CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**On Petition for Review of the Decision of the
Tax Court of the United States**

BRIEF FOR THE RESPONDENT

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INDEX

Opinion below	Page
Jurisdiction	1
Question presented	1
Statutes and Regulations involved	2
Statement	3
Summary of Argument	3
Argument	10
Conclusion	12
Appendix	26
	27

CITATIONS

Cases:

<i>Boyle v. Commissioner</i> , 187 F. 2d 557.....	22, 24
<i>Chandler, Estate of v. Commissioner</i> , 228 F. 2d 909	15
<i>Commissioner v. Roberts</i> , 203 F. 2d 304.....	22
<i>Earle v. Woodlaw</i> , decided February 28, 1957.....	14
<i>Fostoria Glass Co. v. Yoke</i> , 45 F. Supp. 962.....	14
<i>Hirsch v. Commissioner</i> , 124 F. 2d 24.....	14
<i>Jones v. Griffin</i> , 216 F. 2d 885.....	14, 16
<i>Keeffe v. Cote</i> , 213 F. 2d 651.....	25
<i>Kessner v. Commissioner</i> , 26 T. C. No. 134.....	22, 24
<i>Rheinstrom v. Commissioner</i> , 125 F. 2d 790, certiorari denied, 317 U. S. 654.....	14, 24
<i>Smith v. United States</i> , 121 F. 2d 692.....	15
<i>United States v. Gypsum Co.</i> , 333 U. S. 364, rehearing denied, 333 U. S. 869.....	15
<i>United States v. Yellow Cab Co.</i> , 338 U. S. 338....	15
<i>Vesper Co. v. Commissioner</i> , 131 F. 2d 200.....	15
<i>Woodworth v. Commissioner</i> , 218 F. 2d 719.....	14
<i>Yankey v. Commissioner</i> , 151 F. 2d 650.....	21

Statutes:

Internal Revenue Code of 1939:	
Sec. 26 (26 U. S. C. 1952 ed., Sec. 26)	13
Sec. 115 (26 U. S. C. 1952 ed., Sec. 115)	27
Internal Revenue Code of 1954:	
Sec. 7482 (26 U. S. C. 1952 ed., Supp. II, Sec. 7482)	2

Miscellaneous:

Federal Rules of Civil Procedure, Rule 52(a).....	15
H. Rep. No. 2333, 77th Cong., 2d Sess., p. 49 (1942-2 Cum. Bull. 372, 412).....	14
Treasury Regulations 111:	
Sec. 29.115-5	28
Sec. 29.115-9	29

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 77-118) are reported at 26 T. C. 1.

JURISDICTION

This petition for review (R. 119-121) involves federal income taxes for the taxable year 1949. On June 5, 1953, the Commissioner mailed a notice of deficiency to the taxpayer (R. 11-18) and within 90 days thereafter, on August 31, 1953, taxpayer, pursuant to Section 272 of the Internal Revenue Code of 1939, filed a petition in the Tax Court for rede-

termination of this deficiency (R. 3, 4-11). The decision of the Tax Court was entered on April 5, 1956. (R. 118-119.) On July 2, 1956, taxpayer filed a petition for review invoking the jurisdiction of this Court under Section 7482 and 7483 of the Internal Revenue Code of 1954. (R. 119-121.)

QUESTION PRESENTED

Taxpayer owned 2,094 of the 5,182 shares of common stock outstanding of the Western Vegetable Oils Company. In 1949, Western distributed cash in exchange for 1,346 shares of the stock held by taxpayer and in exchange for all of the stock owned by some of the other stockholders. The stock so acquired was then canceled and retired.

¹The question presented is whether the Tax Court clearly erred in holding that the distribution received by the taxpayer was a distribution in partial liquidation within the meaning of Section 115(i) of the Internal Revenue Code of 1939 (and was thus taxable as capital gain, pursuant to Section 115(c) of the Code), as the Commissioner contended, and was not a distribution essentially equivalent to a taxable dividend as provided in Section 115(g) of the Code (and thus was not subject to the dividends received credit of Section 23(b) of the Code) as taxpayer contended.¹

¹ A second issue, involving a change in taxpayer's accounting methods, was decided in favor of the Commissioner (R. 102-113) and has been abandoned by the taxpayer on this appeal (R. 123-124).

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and Regulations involved are printed in Appendix, *infra*.

STATEMENT

The facts as stipulated (R. 20-25) and found by the Tax Court (R. 79-102) may be summarized as follows:

Pacific Vegetable Oil Corporation (hereinafter called taxpayer) is a California corporation having its principal place of business in San Francisco. It keeps its books by the accrual method of accounting, and makes its income tax returns on the basis of a calendar year. (R. 79.)

Western Vegetable Oils Company, Incorporated (hereinafter called Western), is a California corporation having its principal place of business in San Francisco. The corporation was organized in 1935. It carried on a business of producing vegetable oils from copra and other vegetable oil producing materials, and of selling the oil and the by-products in the United States. As of March 31, 1954, it discontinued its copra crushing operations because of unfavorable economic conditions in the copra crushing industry. The outstanding stock of Western consisted of common stock only. (R. 92.)

At the beginning of 1949, there were outstanding 5,182 shares of Western's stock, and such outstanding stock was held, in various amounts, by 10 stockholders, including the taxpayer who held 2,094 shares, or 40.4091 per cent of the outstanding shares. (R. 92.)

Western's outstanding stock at the beginning of 1949 was held as follows (R. 93):

<u>Stockholders</u>	<u>No. of Shares</u>	<u>Percentages</u>
Pacific Vegetable Oil Corporation	2,094	40.4091
A. A. Schumann	1,252	24.1605
S. L. Jones & Co. (transferred to W. A. Dow, a shareholder and officer of S. L. Jones & Co. on June 28, 1949)	900	17.3680
R. J. Bommer	250	4.8244
D. S. Burness	178	3.4350
Muriel Burness	178	3.4350
Estate of P. C. Denroche, Deceased	140	2.7016
Thos. A. Allan	140	2.7016
Paul A. Schumann	25	.4824
F. Nelson	25	.4824
 TOTAL	 5,182	 100.0000

Prior to 1949, Western purchased 698 shares of its stock from the Bank of California, as trustee under the will of R. Carl Eddy, Jr., deceased, and 280 shares of its stock from J. H. Thies. It held these 978 shares of stock as treasury stock at the beninning and during part of 1949. (R. 92.)

In April, 1949, the executor of the estate of P. C. Denroche, deceased, advised Western of its desire to sell 140 shares to Western, and asked for bids. Western's directors were authorized to offer the executor \$120 per share. The executor accepted the offer, and Western purchased the 140 shares on April 30, 1949, for \$120 per share. The stock was held as treasury stock, by Western, until after October 18, 1949. (R. 93.)

During October 1949, Western received offers from other stockholders to sell their Western stock to Western for the book value of \$220 per share, as follows (R. 93-94):

Pacific Vegetable Oil Corp.		1,346	shares
Thomas A. Allan	(all)	140	"
D. S. Burness	"	178	"
Muriel Burness	"	178	"
Paul A. Schumann	"	25	"
F. Nelson	"	25	"

TOTAL

1,892 shares

These offers to sell were accepted and the purchases for \$220 per share were authorized at meetings of Western's board of directors on October 18, 1949, and October 26, 1949, and the stock was purchased by Western on dates in October and November, 1949, following the directors' meetings. (R. 94.)

At the meeting of Western's directors on October 18, 1949, a resolution was adopted to purchase the stock held by taxpayer and by Thomas A. Allan, in which it was stated that the earned surplus of Western was sufficient to enable the purchases and that it was deemed to be to the best interests of Western to purchase the stock. Statements to the same effect appear in the resolutions which were adopted at the directors' meeting on October 26, 1949, when authorization was given to purchase the stock of D. S. Burness, Muriel Burness, Paul A. Schumann, and F. Nelson. (R. 94.)

At the director's meeting on October 18, 1949, a resolution was adopted authorizing the retirement and cancellation of the 698 shares which had been purchased from the trustee under the will of R. Carl Eddy, Jr., the 280 shares which had been purchased from J. H. Thies, and the 140 shares which had been purchased from the estate of Percy C. Denroche, all of which had been held after the purchases as treasury stock. At the same meeting a resolution was

adopted authorizing the retirement and cancellation of the stock to be purchased from taxpayer and Thomas A. Allan. At the directors' meeting on October 26, 1949, a resolution was adopted authorizing the retirement and cancellation of the stock to be purchased from F. Nelson, Paul A. Schumann, D. S. Burness, and Muriel Burness. (R. 94-95.)

Accordingly, before the end of 1949, Western retired and cancelled 978 shares of stock it had purchased before 1949 and held as treasury stock, and it purchased, retired and cancelled, 2,032 shares of the 5,182 shares which were outstanding at the beginning of 1949. Therefore, at the end of 1949, there were 3,105 shares of its stock outstanding out of the 5,182 shares which had been outstanding at the beginning of the year. (R. 95.)

The stock which was outstanding at the end of 1949 was thus held by 4 stockholders, taxpayer, W. A. Dow, R. J. Boomer, and A. A. Schumann in the following amounts (R. 95-96):

<u>Stockholder</u>	<u>No of Shares</u>	<u>Percentage</u>
A. A. Schumann	1,252	39.75
W. A. Dow	900	28.57
Pacific Vegetable Oil	748	23.74
R. J. Boomer	250	7.94
	<hr/> 3,150	<hr/> 100.00

Western paid to the stockholders from whom it purchased stock during 1949, the total amount of \$433,040 for their stock as follows (R. 96):

Estate of P. C. Denroche	\$ 16,800
Thos. A. Allan	30,800
Pacific Vegetable Oil	296,120
D. S. Burness	39,160
M. Burness	39,160
F. Nelson	5,500
P. A. Schumann	5,500
	<hr/>
	\$433,040

Western paid \$220 per share to each of the above-named stockholders, except to the estate of P. C. Denroche to whom Western paid \$120 per share. (R. 96.)

At a meeting of Western's directors on January 4, 1950, the directors considered offers by W. A. Dow (900 shares) and R. J. Boomer (250 shares) to sell all of their stock to Western, 1,150 shares, at \$220 per share. A resolution was adopted authorizing acceptance of these offers by Western, and the retirement and cancellation of the 1,150 shares upon purchase thereof. After Western purchased and retired the above stock, 2000 shares remained outstanding of which A. A. Schumann held 1,252 shares, and taxpayer held 748 shares. (R. 96-97.)

On or about February 17, 1950, taxpayer purchased from A. A. Schumann 252 shares of Western's stock at a price of \$220 per share. Thereafter, taxpayer and A. A. Schumann each owned 1,000 shares, or 50% of the outstanding shares. (R. 97.)

On or about October 24, 1949, after taxpayer sold 1,346 shares of Western stock to Western, taxpayer's remaining stock, 748 shares, then represented 20.1 per cent of Western's outstanding stock. On or about January 10, 1950, after Western bought the stock of Dow and Boomer, taxpayer's 748 shares represented

37.40 per cent of the then outstanding stock, and the 1,252 shares held by A. A. Schumann represented 62.60 per cent of the outstanding stock. (R. 97.)

At the end of 1948, Western's paid-in surplus was \$69,090, and its earned surplus was \$768,299.64. Western's accumulated earnings and profits exceeded, at all times, the payments it made in 1949 for stock which it acquired from various stockholders. (R. 97.)

Western's net income before taxes, income taxes, and paid dividends for the years 1943 through 1947 were as follows (R. 98):

<u>Year</u>	<u>Net Income Before Taxes</u>	<u>Income Taxes</u>	<u>Paid Dividends</u>
1943	\$ 51,119.43	\$ 450.00	\$ 39,060
1944	65,152.50	38,596.21	11,760
1945	75,656.05	44,020.86	10,364
1946	344,858.23	137,115.08	51,820
1947	1,069,837.49	407,179.51	103,640

Western's net income before taxes, or loss, for the years 1948 through 1953, was as follows (R. 98):

<u>Year</u>	<u>Net Income Before Taxes</u>
1948	\$ 88,573.88
1949	358,814.71
1950	(121,440.87)
1951	106,037.90
1952	(32,403.36)
1953	(52,140.97)

Western declared and paid dividends in 1948 and 1949 in the amounts of \$51,820, and \$50,420, respectively, the latter being a cash dividend of \$10 per share, declared on August 16, 1949. No dividends were paid in 1950. (R. 97, 98.)

Western's cash and earned surplus at December 31 of each of the years 1948 through 1953 amounted to the following (R. 98):

<u>Year</u>	<u>Cash</u>	<u>Earned Surplus—12/31</u>
1948	\$448,201.72	\$768,299.64
1949	238,503.21	503,756.80
1950	54,739.69	129,315.93
1951	84,466.05	233,223.71
1952	54,005.10	198,723.82
1953	48,277.30	142,854.72

The increases or decreases in Western's earned surplus for the years 1946 through 1950 were as follows (R. 98-99):

<u>Year</u>	<u>Earned Surplus Increase or (Decrease)</u>
1946	\$155,923.15
1947	558,104.56
1948	3,095.81
1949	(264,542.84)
1950	(374,440.87)

For the years 1948 through 1950, as of December 31 of each year, Western's gross sales, gross profit or loss, expenses, and net taxable income or loss were as follows (R. 99):

<u>Year</u>	<u>Gross sales</u>	<u>Gross Profit or (Loss)</u>	<u>Business Expenses</u>	<u>Net Taxable Income or (Loss)</u>
1948	\$5,617,486.61	\$214,656.89	\$164,308.51	\$ 88,573.88
1949	4,672,896.09	467,787.70	116,865.38	358,814.71
1950	6,373,894.78	(11,829.73	115,888.12	(121,440.87)
1951	6,551,529.94	200,610.82	94,973.52	106,037.90
1952	5,661,159.15	165,790.02	221,689.16	(32,403.36)
1953	6,164,545.29	121,955.34	225,784.28	(52,140.97)

Western carried on its oil manufacturing and copra crushing business from the beginning of its business in 1935 until approximately March 31, 1954. All plant and equipment owned and maintained by Western prior to 1949 continued to be owned and maintained by Western after 1949 to and including March 31, 1954. (R. 99.)

In its income tax return for the year 1949, taxpayer reported the sum of \$296,120, which it received from Western upon its surrender of 1,346 shares of Western, as a dividend, and took a dividend credit, under Section 26(b) of the 1939 Code, of 85 per cent of the sum received, or \$251,702, which left \$44,418 as taxable income received in 1949 from the transaction. (R. 99-100.)

The Commissioner determined that there was a partial liquidation of Western in 1949; that the taxpayer erred in treating the transaction as a dividend, the \$296,120 which taxpayer received in exchange for 1,346 shares of stock of Western representing a recovery of the taxpayer's cost or basis of the stock to the extent of \$18,832, the cost being about \$13.99 per share; and that, accordingly, the taxpayer realized capital gain in the amount of \$277,288. (R. 99, 100.) Accordingly dividend income of \$296,120 and the offsetting credit of \$251,702 were eliminated from taxpayer's net income and the long-term capital gain of \$277,288 was substituted therefor. (R. 101.)

The Tax Court held that the distribution of Western to taxpayer in 1949, in exchange for the 1,346 shares of Western's stock owned by taxpayer, was a distribution in partial liquidation and was not in whole or in part essentially equivalent to the distribution of a taxable dividend. (R. 102.)

SUMMARY OF ARGUMENT

The Tax Court, sustaining the Commissioner's determination, held that the distribution in redemption of part of the stock held by taxpayer was a dis-

tribution in partial liquidation, within the purview of Sections 115(c) and (i) of the Internal Revenue Code of 1939, and was not equivalent to the distribution of a taxable dividend under Section 115(g). The question is one of fact and the conclusion of the Tax Court should be upheld unless it is clearly erroneous.

The courts have set forth a number of relevant criteria which prove useful in reaching the ultimate factual conclusion as to whether a distribution is in partial liquidation or is essentially equivalent to a dividend, the most important of which is the net effect of the actions taken. However, there is no inflexible and unyielding rule of thumb or weighted formula which may be applied in reaching this factual determination and no one factor is necessarily controlling. The answer, instead, depends upon the peculiar circumstances of each case.

Contrary to taxpayer's assertions, the Tax Court did not err as a matter of law. The Tax Court properly recognized that the net effect of the transaction is the test. The court also correctly observed that no one factor is necessarily controlling, but that, instead, each case turns on its own peculiar facts. In addition, the court carefully considered all the factors which the evidence disclosed, the burden being upon the taxpayer, not the Commissioner, to come forward with the relevant facts.

In determining the net effect of the transaction, the Tax Court properly considered the fact that taxpayer's relationship to the corporation was essentially changed as a result of the distribution. The dividend record of the corporation, and the fact that

the distribution was not pro rata, presented the Tax Court with additional bases for its ultimate conclusion. As the Tax Court further noted, the taxpayer failed to come forward with evidence explaining the purpose of the transaction. The Court recognized the availability of sufficient earned surplus from which to make the distributions and the fact that there was no apparent contraction of business activity by the corporation, but, in effect, considered those factors outweighed by the other factors.

The question on this appeal is not whether this Court would have reached the same conclusion as did the Tax Court, but whether the conclusion of that Court is clearly erroneous. There is substantial support for the Tax Court's conclusion, and this Court should not reweigh the evidence and substitute its own inference.

The cases cited by taxpayer as supporting its position merely set forth the relevant criteria and recognize that each case must necessarily turn on its own facts. They are distinguishable on their facts and accordingly are not controlling here.

ARGUMENT

The Conclusion of the Tax Court that the Distribution In Cancellation of Part of the Stock Held by Taxpayer Was a Partial Liquidation and Was Not Essentially Equivalent To a Dividend Is One of Fact and, Not Being Clearly Erroneous, Should Be Affirmed

Sections 115 (a) and (b) of the Internal Revenue Code of 1939 (Appendix, *infra*) lay down the general rule that any distribution by a corporation to its stockholders is a taxable dividend to the extent that

the corporation has available earnings and profits. Section 115(c) (Appendix, *infra*) carves out an exception to this general rule by providing that distributions in complete or partial liquidation shall be treated as payments in exchange for stock, thus giving rise to capital gain or loss. A distribution in partial liquidation is defined by Section 115(i) (Appendix, *infra*) as meaning a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. However, the exception set forth with respect to partial liquidations by Section 115 (c) is in turn curtailed by Section 115 (g) (Appendix, *infra*), which taxes as a dividend, to the extent of available earnings, any cancellation or redemption of stock which occurs "at such time and in such manner as to make the distribution * * * in whole or in part essentially equivalent to the distribution of a taxable dividend."

In this case, taxpayer, a corporation, is attempting to convert into a dividend by means of Section 115 (g), what is in fact, under the particular circumstances of this case, a partial liquidation, in order to obtain the advantage of the 85% dividends-received credit available to corporations holding stock in another corporation. (See Sec. 26(b)(1) of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed., Sec. 26). It should be noted, however, that the thrust of Section 115 (g) is to prevent distributions in partial liquidation from being utilized to disguise the taxation of a taxable dividend and not necessarily to con-

vert what is in effect a partial liquidation into a dividend. See H. Rep. No. 2333, 77th Cong., 2d Sess., p. 49 (1942-2 Cum. Bull. 372, 412); *Rheinstrom v. Conner*, 125 F. 2d 790 (C. A. 6th), certiorari denied, 317 U. S. 654; *Fostoria Glass Co. v. Yoke*, 45 F. Supp. 962 (W. Va.).

The exhaustive decision in *Earle v. Woodlaw*, decided February 28, 1957 (1957 C.C.H., par. 9472) sets forth the most recent pronouncement of this Court with respect to the question of whether a distribution is in partial liquidation or is substantially equivalent to a dividend. In the *Woodlaw* case it was stated:

Before we consider the law applicable to the facts of this instant case, we must first recognize that "most of the cases arising under Sec. 115 (g) are of little value in the determination of the question instantly presented, for the reason that each depends for its solution upon its own peculiar facts."

It is thus well-established that the question in this case is one of fact, dependent upon the particular circumstances of each case. See also, *Hirsch v. Commissioner*, 124 F. 2d 24 (C. A. 9th); *Jones v. Griffin*, 216 F. 2d 885 (C. A. 10th); *Woodworth v. Commissioner*, 218 F. 2d 719 (C. A. 6th); Treasury Regulations 111, Sec. 29.115-9 (Appendix, *infra*.)

The Tax Court in the instant case found that the transaction in question did not have the equivalence of a taxable dividend under Section 115 (g). This ultimate conclusion, being factual, will be reversed only if clearly erroneous. *Earle v. Woodlaw*, *supra*;

Estate of Chandler v. Commissioner, 228 F. 2d 909 (C. A. 6th); *Smith v. United States*, 121 F. 2d 692 (C. A. 3d); Section 7482 (a) of the Internal Revenue Code of 1954 (26 U. S. C. 1952 ed., Supp. II, Sec. 7482); Rule 52(a) of the Federal Rules of Civil Procedure. See also, *United States v. Yellow Cab Co.*, 338 U. S. 338, 340, 342; *United States v. Gypsum Co.*, 333 U. S. 364, 394, 395, rehearing denied, 333 U. S. 869; *Vesper Co. v. Commissioner*, 131 F. 2d 200 (C. A. 8th).

In addition to setting forth the foregoing principles, this court, in the *Woodlaw* case, *supra*, further stated:

“In determining whether a transaction is equivalent to a taxable dividend within Section 115 (g), or whether it is a partial liquidation under 115 (c), neither the Board of Tax Appeals nor the courts have laid down a sole decisive test.” *Flanagan v. Helvering*, D. C. Cir., 116 Fed. (2d) 937.

The cases do, however, lay down certain “judicial criteria,” as Judge Vinson described them in the *Flanagan* case, which have proven useful in coming to a conclusion as to whether Sec. 115 (g) is applicable. These are:

1. Did the corporation adopt any plan or policy of contraction of its business activities?
2. Did the corporation follow an orderly procedure looking toward its ultimate dissolution, or its ultimate contracted operation?
3. Did the initiative for the corporate distribution come from the corporation, based on usual business considerations, or did it come from stockholders, (or a stockholder), for their (or his) own purpose?

4. Is the proportionate ownership of stock by the shareholders changed?

5. What were the amounts, the frequency and the significance of dividends paid in the past?

6. Does the capitalization, at the time of cancellation of the stock, represent capital paid in, or earnings from the business?

7. Was there a sufficient accumulation of earned surplus to cover the distribution, or was it partly from capital?

8. Was there a maintenance of a relatively similar amount of capital liability, or did that figure decrease to a degree somewhat comparable to the purported distribution of capital?

9. Was there good faith, or bad, in the action of the Board of Directors?

10. What was the net effect of actions taken?

This last criteria is that of most importance. And, as the court stated in *Jones v. Griffin*, supra, at p. 887:

No inflexible and unyielding rule of thumb has been devised for ready use in determining in every instance whether a transaction constituted a partial liquidation within the scope and meaning of section 115 (c), or was the equivalent of a taxable dividend within the purview of section 115(g). A critical examination of the statute as a whole negates the suggestion that a weighted formula can resolve the crucial question in every case.

Taxpayer, the Commissioner and this Court apparently agree that the basic test is the net effect of the transaction. (See Pet. Br. 10-11.) It is also apparent that the four factors which taxpayer asserts

are of importance (Br. 11-12) are relevant in determining whether a distribution is essentially equivalent to a dividend or is a partial liquidation. However, the Commissioner contests the implication that the four factors enumerated by taxpayer are the only factors of (Br. 11) "primary" or "major" importance and also contests the assertion that the Tax Court gave disproportionate weight to what the taxpayer submits as (Br. 12-13) "relatively unimportant" factors. As already noted, there are any number of factors and circumstances which are relevant and which may be present in innumerable combinations; there is no "rule of thumb" which may be applied in reaching this factual determination and no one factor is controlling. The answer depends on the peculiar circumstances of each case.

Taxpayer asserts that the Tax Court erred as a matter of law. (Br. 12.) However, it is clear that the Tax Court committed no error of law in this case. The Tax Court, in arriving at its ultimate conclusion, properly recognized that the net effect of the transaction is to be considered. The Court correctly observed that no one factor is controlling, but that, instead, each case turns in its own facts. In addition, the Court carefully stated that it considered all the relevant factors which the evidence disclosed.² The issue before the Tax Court was purely factual and the only

² At this point, it should be noted that the determination of the Commissioner is *prima facie* correct and the burden is on the taxpayer to prove the existence of any factors in its favor in order to prove the determination incorrect. *Hirsch v. Commissioner, supra.*

question on this appeal is not whether the Tax Court erred as a matter of law, but whether the finding of the Tax Court is clearly erroneous. We submit that there is substantial evidence to support the Tax Court's finding that the distribution to taxpayer, in view of all the circumstances of this particular case, constituted a distribution in partial liquidation and was not substantially equivalent to a taxable dividend.

Turning to the facts surrounding the transaction in question, prior to 1949, Western held 978 shares of its stock, as treasury stock, which it had purchased from two of its shareholders, these shareholders ceasing to have any interest in the affairs of Western. At the beginning of 1949, the remaining outstanding stock of Western was held by ten stockholders: taxpayer held 2,094 shares (approximately 40 per cent of the outstanding stock); A. A. Schumann held 1,252 shares (approximately 24 per cent of the outstanding stock); and eight other stockholders held the remaining 1,836 shares (approximately 36 per cent of the outstanding stock) in varying amounts. (R. 92-93.)

In April, 1949, the estate of one of the stockholders offered to sell all of the 140 shares held by the deceased stockholder to Western. It being deemed in the best interest of Western, the corporation purchased the shares for \$120 per share and held them as treasury stock. (R. 26-27, 93.)

In October, 1949, Western received an offer from taxpayer to sell 1,346 of its 2,094 shares. At the same time, Western received an offer from one of the other stockholders, Thomas A. Allan (who was also a director of Western), to sell all of the 140 shares

held by him. The offering price for taxpayer's and Allan's shares was the book value thereof, \$220 per share. On October 18, 1949, the Board of Directors of Western accepted the offers, stating that such acceptance was to the advantage and best interests of Western, and authorized the purchase of the shares from taxpayer and Allan. At the same time, the directors authorized the retirement and cancellation of the shares held as treasury stock and also of the shares just purchased. (R. 28-32, 93-95.)

On October 26, 1949, the Board of Directors of Western met to consider additional offers to sell outstanding shares of its stock held by four other shareholders (Paul A. Schumann, F. Nelson, Muriel D. and Donald S. Burness). Each offered to sell all of his or her shares for the book value thereof, \$220 per share. (Paul A. Schumann and Nelson owned 25 shares each and the Burnesses owned 178 shares each.) This offer was accepted by the directors and it was further resolved to retire and cancel the shares so acquired, both the purchase and the cancellation expressly being to the advantage and best interests of Western. (R. 32-35.)

On January 4, 1950, the directors met to consider offers by R. J. Boomer and William A. Dow, Jr. who were directors of Western and were two of the four remaining shareholders to sell all of the shares they held in Western for the book value of \$220 per share (Boomer owned 250 shares and Dow owned 900 shares). The directors accepted the offer and further resolved to cancel the shares, once again stating such action to be to the advantage and best interests of Western. (R. 35-38.)

At this point, only taxpayer and A. A. Schumann remained as stockholders, the former holding 748 shares (37.4 per cent of the 2,000 remaining outstanding shares) and the latter holding 1,252 shares (62.6 per cent of the 2,000 remaining outstanding shares). Then, on or about February 17, 1950, taxpayer purchased 252 shares directly from A. A. Schumann, with the result that each then held 1,000 of the 2,000 shares outstanding. (R. 97.)

During this entire series of transactions, no distributions by Western were made to A. A. Schumann in consideration for the purchase and cancellation of any of the stock held by him. Cash dividends, however, of ten dollars per share were paid in 1948 and on August 16, 1949, to all stockholders of record (R. 97, 98) and dividends were paid in the years 1943-1947, inclusive, in the respective amounts of \$39,060; \$11,760; \$10,364; \$51,820; and \$103,640 (R. 98).

It is undisputed that the distribution to taxpayer was in complete cancellation and redemption of a part of Western's stock. (R. 95.) This fact alone, of course, does not preclude Section 115 (g) from operating to cause treatment of the distribution as a dividend, but merely places it within the definition of Section 115 (i).³ Similarly, there is no dispute that there was sufficient earned surplus available from which to make the distributions in 1949 and

³ The first part of the definition of the term "amounts distributed in partial liquidation" is " * * * a distribution by a corporation in complete cancellation or redemption of a part of its stock." Sec. 115 (i) of the Internal Revenue Code of 1939.

the exhibits to the stipulation indicate that such distributions were charged to earned surplus (Ex. 8-H, R. 41; Ex. 9-I, R. 42). It also appears that there was, in fact, no contraction in the business or operating assets of Western from the time of the distribution, in 1949, until the business ceased operations in 1954, due to unfavorable conditions in the copra crushing industry. (R. 21, 99.) These are admittedly relevant factors to consider, but they are not conclusive, *per se*, of the ultimate factual issue.⁴ As the Tax Court properly noted (R. 117), no one factor is controlling. The Tax Court did not ignore these factors, but, instead, expressly recognized them (R. 116-117). The court, in effect, held that other factors present in the particular circumstances of this case, particularly the net effect of the essential change of taxpayer's relationship to the corporation, outweighed the existence of earnings and lack of contraction of business.

The Tax Court placed particular emphasis on the net effect of the transaction in question, specifically noting that taxpayer's relationship to Western was essentially changed after the distribution in question. (R.115-116.)⁵ Prior to the series of distributions,

⁴ The fact that a distribution is out of earnings is merely one of many relevant factors to be considered, as taxpayer recognizes. Similarly, the lack of a policy of contraction does not, in and of itself, preclude the distribution from being one in partial liquidation. See *Yankey v. Commissioner*, 151 F. 2d 650 (C. A. 10th).

⁵ Thus the Tax Court recognized the fourth and tenth criteria listed by this Court in the *Woodlaw* case (i.e., whether the proportionate ownership of stock by the shareholders changed and the net effect of actions taken).

taxpayer held approximately 40 per cent of the stock in Western. Immediately after the distribution in exchange for part of the stock held by taxpayer, on October 18, 1949, taxpayer held approximately 20 per cent of the shares outstanding. (R. 115-116.) And if, as taxpayer asserts (Br. 21), and the Commissioner agrees, the series of integral stock transactions amounted to a plan, the net effect was that taxpayer ultimately held equal control of Western, whereas before the series of redemptions, and the subsequent direct purchase of stock by taxpayer from A. A. Schumann,⁶ taxpayer controlled only 40 per cent of the stock. The Tax Court was certainly justified in considering this a significant change in the proportionate ownership of Western.⁷ Furthermore, the net effect of the over-all plan of distributions significantly changed the structure of stockholdings. Prior to the distributions, there were ten stockholders, eight of

⁶ The record does not disclose the relationship between taxpayer and A. A. Schumann.

⁷ This case thus differs factually from *Commissioner v. Roberts*, 203 F. 2d 304 (C. A. 4th); *Boyle v. Commissioner*, 187 F. 2d 557 (C. A. 3d); and *Kessner v. Commissioner*, 26 T. C. No. 134, relied upon by taxpayer (Br. 18-21, 32-39.) The *Roberts* case (as did the *Woodlaw* case, *supra*) presented a fact situation in which there was a sole stockholder. Naturally, any redemption in that situation would not affect the relative position and control of the stockholder with respect to the corporation. In the *Boyle* case, there were three stockholders, each holding one-third of the shares; after the redemption of three stockholders remained in the same relative position, each holding the same one-third interest. Similarly, in the *Kessner* case, there was no change in the proportionate holdings.

whom held about 36 per cent of the stock, and who, together with either taxpayer or A. A. Schumann, could control the company. After the series of redemptions, these eight stockholders were no longer on the scene and there remained only taxpayer and A. A. Schumann, each holding 50 per cent of the stock, or equal control of Western. All of these transactions, which taxpayer recognizes as an integral part of an over-all plan, were found by the Tax Court to be bona fide, arm's-length transactions (R. 116) and had the net effect of materially altering the ownership and control of Western.

The Tax Court also noted the dividend record of Western as further proof that the distribution in question was not essentially equivalent to a dividend. (R. 117.) Taxpayer's criticism of the Tax Court (Br. 24-28) with respect to the Court's consideration of the prior dividends (as well as with respect to the Court's consideration of a lack of a pro rata distribution) does not fairly present the Tax Court's opinion. The Tax Court did not base its main reliance on these factors, but instead (1) noted that no one factor is controlling, (2) stated that it considered all of the factors which the record disclosed and then (3) noted these as among the factors in question. Taxpayer attempts to set up a hierarchy of four major factors and relegate others to a "minor" status. The fact is that *all* of the factors have some degree of relevance. This Court, in the *Woodlaw* case, *supra*, expressly recognized the relevancy of an examination of the amounts, frequency and significance of past dividends. Here, Western had paid dividends amount-

ing to \$10 per share in 1948 and 1949 and had consistently paid substantial dividends since 1943 (R. 98.) There is nothing to show, as in the *Woodlaw* case, that Western, for the convenience of the shareholders, failed to pay dividends when the corporation would ordinarily have done so.

With respect to the fact that the distributions were not pro rata, the presence of a pro rata distribution is of course strong evidence that the distribution is equivalent to a dividend, since the net effect is to leave the stockholders in the same relative position. Indeed, even a non-pro rata distribution may be essentially equivalent to a dividend. See *Boyle v. Commissioner*, 187 F. 2d 557 (C.A. 3d); *Kessner v. Commissioner*, *supra*. However, while it is not conclusive, the fact that a distribution is not pro rata may properly be considered a factor indicative of a liquidation rather than a dividend distribution. Here, the fact that A. A. Schumann received no comparable distribution fits the general plan of redemption of stock whereby taxpayer and Schumann achieved equal ownership and control of Western, and the Tax Court was not in error in noting it as relevant.

Finally, with respect to whether the stock redemption served a business purpose of the corporation as contrasted with a benefit accruing solely to the stockholders, it should again be noted that throughout the consideration of all the factors in this and similar cases, the Commissioner's determination is *prima facie* correct and the burden is on the taxpayer to prove the existence of factors in its favor in order to prove the determination incorrect. *Rheinstrom v.*

Commissioner, supra; Hirsch v. Commissioner, supra. The corporate minutes in the case of each distribution and cancellation expressly state that such action was to the advantage and best interest of Western (R. 27, 29, 31, 33, 34, 37.⁸ The Tax Court noted that there is no evidence or testimony relating to these transactions which would explain them (R. 117-118).

Taxpayer finally states that the leading cases support its position (Br. 29-39.) However, the cases merely set forth relevant criteria, which the Tax Court considered, and recognize that each case must turn on its own facts. Accordingly, other decisions are of little value in the determination of the issue in this and similar cases. *Earle v. Woodlaw, supra.* Furthermore, as already discussed, the cases are clearly distinguishable from the instant case.

⁸ In *Kessner v. Commissioner, supra* (relied upon by taxpayer), the Tax Court, in holding the distribution to be a dividend, noted that the minutes of the directors' meeting contained no expression of a business purpose. It might also be noted that where the corporation is closely held, it is often difficult to distinguish a corporate from a stockholder's purpose. *Keefe v. Cote*, 213 F. 2d 651, 657 (C.A. 1st).

CONCLUSION

It is submitted that, on the particular facts of this case, the ultimate conclusion of fact by the Tax Court was not clearly erroneous and should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [As amended by Sec. 166 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Dividend.*—The term “dividend” when used in this chapter (except in section 201 (c) (5), section 204 (c) (11) and section 207 (a) (2) and (b) (3) (where the reference is to dividends of insurance companies paid to policy holders) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

(c) [As amended by Sec. 147 of the Revenue Act of 1942, *supra*] *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribu-

tion which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

* * * * *

(g) *Redemption of Stock*.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * *

(i) *Definition of Partial Liquidation*.—As used in this section the term “amounts distributed in partial liquidation” means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.115-5. *Distributions in Liquidation*.—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined as provided in section 111 and section 29.111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent pro-

vided in section 112, and shall be subject to the conditions and limitations provided in section 117.

The term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. A complete cancellation or redemption of a part of the corporate stock may be accomplished, for example, by the complete retirement of all the shares of a particular preference or series, or by taking up all the old shares of a particular preference or series and issuing new shares to replace a portion thereof, or by the complete retirement of any part of the stock, whether or not pro rata among the shareholders.

In the case of amounts distributed in partial liquidation, the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of section 115(b) for the purpose of determining taxability of subsequent distributions by the corporation. (See sections 29.27(g)-1 and 29.115-11.)

* * * * *

Sec. 29.115-9. Distribution in Redemption or Cancellation of Stock Taxable as a Dividend.—

If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock

is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.